Modern Monetary Theory

By Brian Fabbri

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Many proponents, both serious and delirious

The Federal Reserve has begun to attract many critics. Not just the President of the United States, but most recently a determined group of acclaimed academic economists and pseudo economic posturers who have attached themselves to a winning economic solution without having to consider the intended and unintended costs of that solution. The theory is called Modern Monetary Theory (MMT). The Federal Open Market Committee (FOMC) of the Federal Reserve is also investigating the theory (directing their 13 research departments to analyze it), just in case their present strategy breaks down.

MMT is gaining political adherents

The idea of MMT is not new, but it is recently gaining more traction because politicians in the US are seizing upon its promises. The adherents believe that a government that is able to borrow in its own currency need not be constrained by budget deficits and debt ratios. Thus, the politically appealing part is that governments can act more boldly than economists have previously assumed, without negative consequences. The MMT proponents state that when private demand is insufficient to create full employment the government can and should guarantee full employment by financing employment wages with federal spending. They further assert that federal spending is much more robust in promoting full employment than when macro-economic policy is more heavily dependent upon central banks conducting monetary policy by raising and lowering interest rates.

The principal political idea behind the theory is that Congress should spend enough money in order to achieve full employment growth, and that its only constraints should involve the available real-world resources of labor and materials to carry out those spending ambitions. If it causes inflation to accelerate beyond some tolerable threshold,
then government spending would have to be restricted, or taxes raised.

The theory rests on the ability of a country to borrow money in its own currency and advocates assert that a country that prints its own money has no need to default on its debt. While it’s probably true that a government with its own currency can’t go bankrupt, it can destroy that currency if it loses fiscal credibility. Moreover, history offers numerous examples of countries using money printing as a solution for a lack of private buyers for their debt (most recently Greece and Argentina). Both suffered from a vicious cycle of rising inflation, crippling high borrowing costs, and internationally enforced economic constraints on their government’s economic sovereignty.

**Debt credibility is determined by investors**

Investor acceptance of public or private debt worthiness isn’t a permanent state of affairs. It is entirely based upon a borrowers’ credibility, which a country (or private borrower) can gain and lose as countless nations have over the centuries. The traditional view of national debt credibility is attained over time through government policies that promote low inflation, create an independent central bank, have a strong legal system, and maintain good governance.

**The EU: home of the most traditional macro policy**

The European Union created its own definition of debt worthiness by establishing a set of budget/debt guidelines that member countries should follow. For example, national budget deficits should not exceed 3% of the nation’s GDP, and the outstanding stock of national debt should not exceed 60% of it’s GDP. Not all member countries have adhered to these standards all the time. Whenever a member country has egregiously breached these benchmarks, the EU commission has imposed serious constraints on the offending nation’s annual budget policies.

![EU composite government debt to GDP ratio is well over EU standard](chart.png)

Presently, most larger member nations are adhering to the spirit of these standards, if not the actual limitations. The excess debt reflected in the EU composite (see chart above) is primarily due to Greece, Italy, Spain and some of the smaller members. The above target debt ratio for the EU composite reveals how aggressive fiscal policy has been relied upon by many EU member countries.

Moreover, most EU sovereign, 10-year bond interest rates are yielding next to nothing, or
in some cases below zero (Germany and France). Consequently, above target sovereign debt ratios and sustained ECB purchases of sovereign securities have not led to higher bond yields; in fact just the opposite. The implication from near zero interest rates on sovereign bonds in the EU is that investors believe that the ECB is incapable of raising inflation rates to, or above the ECB’s 2% target.

**Japan: a living example of MMT**

The serious proponents of MMT point to Japan and cite Japanese monetary and fiscal policy history over the past two or three decades as having employed the MMT techniques. Authorities from the Bank of Japan have refused to acknowledge the use of this policy and the national government has stated that it is not employing MMT. Nevertheless, a few charts may point out the inevitable congruence between recent Japanese economic history and MMT.

First, the Japanese government has amassed an absolute mountain of public debt. Virtually all of it is in Japan’s currency, the Yen. And, similarly most of it is owned by Japanese individuals, Japanese financial institutions and the Central Bank of Japan. At the end of the first quarter of 2019 public debt totaled 1,304 trillion yen, which when converted into US dollars at today’s exchange rate totals approximately $12 trillion. In comparison, the US public debt is $22 trillion. However, the most significant comparison from an MMT perspective is Japan’s government debt relative to its GDP.

As the following chart reveals, it is 235% and it has been over 200% since 2010. In comparison, US public debt is 77% of current GDP.

Second, admirers of MMT point out that interest rates in Japan remain extremely low in spite of the massive amount of debt the government issued. Moreover, the economy has improved and living standards have remained high compared with other developed economies.

The third salient fact MMT supporters point to is the enormous amount of Japan’s government debt that the Bank of Japan has purchased over the past two decades.
The BOJ was an early and ardent proponent of quantitative easing and started employing it in the early 1990’s after Japan’s economic bubble burst. The BOJ’s assets increased 4.53 times in the past 9 years after inching ahead at a very modest pace in the previous 12 years. The BOJ recognized early that extremely low interest rates were not sufficient to stimulate faster GDP growth.

The official BOJ interest rate governing commercial bank reserves and the benchmark 10-year Japanese government bond yields are both below zero and have been for the past three years. Consequently, interest rates declined significantly when the BOJ embarked upon an unprecedented strategy of purchasing a massive amount of government securities. Thus, extremely loose monetary policy supported Japan’s government when they pursued highly aggressive fiscal support for their suffering economy.

The fourth point, the one that captures the MMT proponents complete attention, is the relationship between Japan’s GDP recovery in the past decade and the contemporaneous expansion of the BOJ’s balance sheet.

Finally, critics of MMT contend that issuing massive amounts of government securities will crowd out private sector borrowers, and, drive interest rates significantly higher. Moreover, when central banks finance substantial portions of government debt it traditionally has led to an acceleration of inflation and a serious devaluation of it’s currency.

However, the recent economic history in Japan does not provide any satisfactory evidence that these consequences have
occurred. Instead, inflation has been negligible for more than a decade and the Yen has not seriously depreciated over the same period. Japan’s recent economic data strongly suggests that MMT might improve every nation’s economic performance.

**Conclusion: destructive idiocy, or not?**

MMT is not consistent with mainstream macro-economic theory or policy. Famous traditional macro economists have weighed in vigorously attacking MMT as destructive idiocy.

Nevertheless, proponents of MMT point to Japan’s recent economic history and cheerfully aver that this is a large modern economy that is enjoying admirably high living standards while bursting through all of the widely proclaimed conventional debt standards that the rest of the developed world have attempted to adhere to.

A significantly powerful current example of how traditional macro policy has not led to positive results is the EU. It has promulgated the most conservative traditional macro-economic policies over the past two decades and they have condemned the EU to have the slowest economic growth among all the developed economic regions.

While MMT seems to be working for Japan, it may not work everywhere. Japan is a relatively closed economy where the government issues all of its debt in Yen and almost all of it is purchased domestically. In contrast, the US economy is more open and it’s public debt is widely held by many foreign institutions: more than half is owned by international investors including nearly all central banks. The dollar is a reserve currency that backs many international currencies and therefore many central banks buy and own US public debt.

In summary, MMT is here! It is employed by all developed economies’ central banks and Federal governments at least in part without creating the predicted negative consequences in any economic region. Perhaps it is time to rewrite the economic textbooks and advise all developed economies to increase their applications of MMT to their economies. Since modern business cycles appear to be metamorphosing into new uncertain forms where economic growth is significantly slower, inflation nearly nonexistent, interest rates are hovering about zero, and central banks have almost exhausted their traditional policy tool: interest rates, MMT may be needed to remedy this new economic dilemma.

*For more information, please contact camri@nus.edu.sg*
### KEY INDICATORS TABLE (AS OF 31 MAY 2019)

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*Source: Bloomberg*

### APPENDIX

**GLOSSARY OF KEY TERMS** (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)

- **S&P500**: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
- **FTSE**: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
- **NIKKEI**: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
- **HANG SENG**: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
- **STI**: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
- **EUR**: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
- **YEN**: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
- **CMCI**: Constant Maturity Commodity Index (CMCI
- **Oil**: West Texas Intermediate prices, $ per barrel (CLK1)
- **3MO LIBOR**: interbank lending rate for 3-month US dollar loans (US0003M)
- **10YR UST**: 10-year US Treasury yield (IYC8 – Sovereigns)
- **10YR BUND**: 10-year German government bond yield (IYC8 – Sovereigns)
- **10YR SPG**: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
- **10YR SGS**: 10-year Singapore government bond yield (IYC8 – Sovereigns)
- **US ISM**: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
- **EU PMI**: Purchasing Managers’ index for the 17 country EU region (PMITMEZ)
- **JP TANKAN**: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
- **CHINA IP**: China’s Industrial Production index, with 1-month lag (CHVAIOY)
- **LC**: Local Currency

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